83-1024

NO. ____

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1983

TRIO MANUFACTURING COMPANY
Petitioner,

vs.

UNITED STATES OF AMERICA,
Respondent.

On Certiorari To The United States Court of Appeals For The Eleventh Circuit

PETITION FOR A WRIT OF CERTIORARI

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December 19, 1983

QUESTION PRESENTED

Whether tax accrual work papers prepared by an independent auditor are subject to administrative summons by the Internal Revenue Service without a showing of particularized need. This question is presently before the Court in United States v. Arthur Young Company, 677 F.2d 211 (2d Cir. 1982), cert. granted, ___ U.S. ___, 103 S.Ct. 1180 (1983).

INTERESTED PARTIES

The following persons may have an interest in the outcome of this case:

Trio Manufacturing Company
(Petitioner)

United States of America (Respondent)

George B. Pennington, CPA

Willis H. Newton and Lee M. Newton

Douglas P. McCallum, Special Agent,
Internal Revenue Service

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NO.____

In The

Supreme Court of the United States

October Term, 1983

Trio Manufacturing Company,

Petitioner,

vs.

United States of America,

Respondent.

On Certiorari To

The United States Court of Appeals

For The Eleventh Circuit

PETITION FOR A WRIT OF CERTIORARI

OPINION BELOW

The opinion of the Court of Appeals is officially reported as In the Matter of the Tax Liability of Willis H. Newton,

Lee M. Newton and Trio Manufacturing Company; United States of America and Douglas P. McCallum, Special Agent Internal Revenue Service, v. George B. Pennington, CPA, 718 F.2d 1015 (11th Cir. 1983), and is reproduced as Appendix A at pages A-1 through A-35.

JURISDICTION

The judgment of the Court of Appeals for the Eleventh Circuit was entered on November 3, 1983. (Appendix B, pages B-1 through B-2) A motion to stay the mandate of the Court of Appeals was granted on December 13, 1983, for the period to and including December 21, 1983. This petition for certiorari was filed within 90 days of the date of judgment and prior to the issuance of a mandate.

This Court's jurisdiction is conferred under 28 U.S.C. § 1254.

STATUTE INVOLVED

Section 7602 of the Internal Revenue Code of 1954, as amended, 26 U.S.C. § 7602, provides in relevant part:

> Section 7602. Examination of books and witnesses
>
> (a) Authority to summon, etc. - For the purposes of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of such internal revenue tax, or collecting such liability, the Secretary or his

delegate is authorized -

> (1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry;
>
> . . .
>
> (3) To take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry.

STATEMENT OF THE CASE

Petitioner is Trio Manufacturing Company, a Georgia corporation (herein called "Trio"). For the years 1977, 1978 and 1979, audited financial statements of the books of account of Trio were prepared in accordance with generally accepted auditing principles. These statements were provided to lenders and were otherwise used by Trio

in the course of business. Trio is not subject to the reporting requirements of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-781 (herein called the "Exchange Act").

Respondent is the United States of America acting through the Internal Revenue Service (the "Service"). The Service is examining the federal income tax liability of Trio for the years 1977, 1978 and 1979.

As part of that examination, the Service, acting under the authority of 26 U.S.C. § 7602, issued an administrative summons to George B. Pennington, a certified public accountant. 718 F.2d at 1016-1017 (App. A-3 through A-5). For those years, Mr. Pennington conducted an examination of Trio's accounts and issued his report, which stated, with one minor exception not relevant

here, that the examination had been made in accordance with generally accepted auditing standards.

After issuance of the summons, Trio exercised its right under 26 U.S.C. § 7609 to stay compliance by Mr. Pennington until Trio's objections were litigated.

The United States petitioned the district court, under 26 U.S.C. §§ 7402(b) and 7604(a), to enforce inter alia the summons at issue.[1/]

[1/] A summons was also issued to Mr. Pennington to compel production of records relating to Willis H. and Lee M. Newton (the "Newton Summons"). For the purpose of the enforcement hearing, the actions to enforce the Newton Summons and the summons relating to Trio were consolidated. The district court ordered enforcement of the Newton Summons and the Eleventh Circuit denied

(Footnote Continued on Next Page)

The petition for enforcement was referred to a United States Magistrate to conduct a show cause hearing at which the government chose to rest on the allegations made in its petition for enforcement and the declaration of Special Agent McCallum, who had issued the summons. The government then tendered Agent McCallum and other government personnel involved in the case for cross-examination by Petitioner.

1/ (Footnote Continued from Previous Page)

a stay of the enforcement order. Mr. Pennington subsequently provided information that was called for by the Newton Summons and rendered an appeal of that enforcement order moot. However, the Newtons do not abandon their objections as regards the admissibility and use of the information obtained thereby in any subsequent proceedings.

(5-R. Vol. 10-11)[1/] During the questioning of Agent McCallum, Trio "attempted to discover whether the Service sought tax accrual work papers by directly asking the agent who drafted the summons. The agent responded that he was unfamiliar with such documents." 718 F.2d at 1018 (App. A.-13)

The magistrate issued his report and recommendation that the summons in the matter of Trio's tax liability be enforced in its entirety. (3-R Vol. 294-300) The report of the magistrate was adopted without comment by the district court. (4-R Vol. 488)

[1/] "R." references are to the five-volume record of the summons enforcement action. "Sup. R." references are to the three-volume record of the contempt action brought by the government against Mr. Pennington.

Trio then appealed to the Eleventh Circuit. The Eleventh Circuit granted a partial stay of the district court's enforcement order. The stay was limited to the tax accrual work papers. Pennington then produced all of the summoned materials except those that Trio asserted fell within the Eleventh Circuit's stay. 718 F.2d at 1017 (App. A-9).

The tax accrual work papers withheld by Pennington were 21 pages which included work papers, notes, memoranda or other documents that were generated by Pennington in his role as auditor and used in verifying the accuracy of the financial statements of Trio for contingent tax liability, including the analysis and opinions of the auditor as to the strength, fairness, reasonableness and weakness of Trio's reporting

of transactions for federal income tax purposes. Those documents and testimony of the accountant relating to the documents and disclosures made by the client that were used in preparing these documents were withheld under authority of the stay granted by the Eleventh Circuit. (Supp. R. Vol. III-22)

The United States filed a motion in district court seeking to have Mr. Pennington held in contempt. After a hearing and in camera inspection of the 21 pages, the district court found the 21 pages to be tax accrual work papers and denied the government's application for contempt against Pennington. 718 F.2d at 1017 (App. A-9). An appeal was taken by the United States from the district court's denial of its contempt motion. The Eleventh Circuit

consolidated the appeals of Trio and the United States for purposes of consideration and disposition.

In its opinion, the Eleventh Circuit first rejected, as being "without merit", the government's argument that Trio had not adequately raised defenses as to production of tax accrual work papers. However, the Circuit Court held that it was not a defense to the summons that the government had failed to show particularized need for the tax accrual workpapers. In so holding, the Eleventh Circuit explicitly declined to follow and rejected the rationale and holding of the majority of the Second Circuit panel in United States v. Arthur Young Company, 677 F.2d 211 (2d Cir. 1982), cert. granted, ___U.S. ___, 103 S.Ct. 1180 (1983), and "embrace[d] instead

the position taken by Judge Newman in dissent." 718 F.2d at 1021 (App. A-26).

The Eleventh Circuit stated that the issue of the Service's right of access to tax accrual work papers is to be resolved as follows:

> Congress' explicit grant of summons power to the IRS should not be limited by a newly recognized privilege unless Congress itself chooses to so limit IRS authority.

718 F.2d at 1021 (App. A-28)

Given its holding that Congress, not the courts, should decide if the Service is required to show particularized need before obtaining tax accrual work papers, the Eleventh Circuit did not address the question of whether a showing of particularized need would be required only as to tax accrual work papers of large corporations, which are

subject to the reporting requirements of the Exchange Act.

The Eleventh Circuit also held that the government had met its required showing of relevancy under United States v. Powell, 379 U.S. 48 (1964), since "tax accrual work papers are relevant as a matter of law to a legitimate investigation of a corporation's correct tax liability." 718 F.2d at 1019 (App. A-17). On the basis of that holding, the court concluded that it was "unnecessary to discuss the further burdens of proof required in a summons enforcement proceeding." Id.

As to the government's appeal, the court found that in view of its prior partial stay of the summons enforcement order, the district court did not abuse its discretion in denying

the government's contempt motion against Pennington.[1/]

On November 21, 1983, Trio filed a motion with the Eleventh Circuit requesting a stay of the mandate of that court pending Trio's petition to this Court for a writ of certiorari. On December 13, 1983, the Eleventh Circuit entered a conditional order staying the mandate. To continue the stay in effect until disposition of this case by the Court, the Eleventh Circuit requred Trio to file, which it has done, a petition for certiorari no later than December 21, 1983.

[1/] Trio does not seek to have the Court review this portion of the Eleventh Circuit's decision since the United States was without legal or factual basis to assert contempt sanctions against Mr. Pennington.

ARGUMENT

A. A CONFLICT EXISTS AMONG THE CIRCUITS AS TO WHETHER THE IRS MUST SHOW PARTICULARIZED NEED TO OBTAIN TAX ACCRUAL WORK PAPERS.

The holding of the Eleventh Circuit that the Service is not required to show particularized need to obtain tax accrual work papers is clearly in conflict with the decision of the Second Circuit in United States v. Arthur Young Company, 677 F.2d 211 (2nd Cir. 1982), cert. granted, __ U.S. __, 103 S.Ct. 1180 (1983).[4/]

[4/] In holding that tax accrual work papers are relevant to an Internal Revenue Service investigation as a matter of law, the decision of the Eleventh Circuit is also in conflict with the reasoning and holding of the Tenth Circuit in United States v. Coopers and Lybrand, 550 F.2d 615 (10th Cir. 1977).

The Court has granted a petition for certiorari and will review the Second Circuit's decision in Arthur Young. The legal and policy issues presented by this petition are the same as in Arthur Young.[5/] As to Trio, the validity of the Eleventh Circuit's decision should be judged based on this Court's determination of whether the Service must show particularized need in order to obtain tax accrual work papers.

[5/] The Fifth Circuit, in United States v. El Paso Company, 682 F.2d 530 (5th Cir. 1982), (petition for cert. pending), likewise rejected the Second Circuit's analysis in Arthur Young. However, the documents at issue in El Paso were not tax accrual workpapers prepared by an independent auditor.

B. THE ISSUE PRESENTED IN THIS CASE HAS SIGNIFICANT EFFECT ON THE PUBLIC INTEREST.

In order to protect the public interest and the integrity of the independent auditing process, the tax accrual work papers of independent auditors should be protected from routine access by the Service. The protection should be extended to all corporations publishing financial statements passed on by independent auditors.

The rationale of the Second Circuit in Arthur Young is initially founded on a concern that a conflict is created between the federal tax and securities laws. The securities laws demand a full disclosure of all material facts which may affect an investor's review of an entity's operation and assets. The

Second Circuit believed that an important aspect of this disclosure mechanism was audited financial statements and that the integrity of such financial statements might be harmed if the Service were allowed routine access to tax accrual workpapers.

The provision of the securities laws cited by the Second Circuit requires a company subject to SEC reporting under the Exchange Act to file financial statements. 15 U.S.C. § 781. The financial statements are to be accompanied by an independent accountant's report which states that the financial statements have been verified in accordance with generally accepted auditing standards. 17 C.F.R. § 210.2-02.(b), SEC Regulation S-X.

A company's liability for making reports under the Exchange Act is determined merely on the basis of the amount of its assets and the number of its shareholders.[5/] Other securities laws mandate the use of audited financial statements as part of their scheme of disclosure to provide potential investors with information upon which to make an investment decision.

For example, Regulation D, as promulgated by the SEC, was issued for the explicit purpose of simplifying

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5/ The Exchange Act requires, in general, that corporations engaged in interstate commerce which have more than 500 shareholders and total assets in excess of $1,000,000 to file annual audited financial statements with the Securities and Exchange Commission. 15 U.S.C. § 781, section 12(g)(1) of the Exchange Act. By regulation, the SEC has exempted issuers that have total assets not exceeding $3,000,000, 17 C.F.R. § 240.12g.1.

exemptions from registration under the Securities Act of 1933, 15 U.S.C. § 77a et seq., in order to facilitate capital formation for small businesses consistent with the protection of investors. Securities and Exchange Commission Release No. 33-6389 (April 15, 1982). For investors who are not deemed to be sufficiently able to absorb the economic risk of investment, entities that offer securities under Regulation D must provide audited financial statements to "non accredited" investors. 17 C.F.R. § 230.502(b)(2)(i). In offerings under Regulation D, the SEC does not review the sales material or financial statements which are given to potential investors. Nor are Regulation D offerings subject to the scrutiny of investment professionals

who regulate the national stock exchanges.

Accordingly, the "chilling effect" found to be potentially present if the Service was granted random access to tax accrual work papers also exists as to the business affairs of companies which are not subject to the reporting requirements of the Exchange Act. The public interest that is to be protected is the independent auditing process.

Additionally, the role and importance of audited financials is not, today, limited to communication with shareholders or potential investors. The financial statements of an entity are often required and relied upon in numerous commercial transactions. They constitute the means by which a corporation conveys information to its bankers, creditors or suppliers. The

integrity of a financial statement which states that it has been examined by an independent auditor and contains his conclusion that the statement is fair and accurate has developed a place in commercial transactions, which should not be disturbed or harmed, without compelling reasons.

If this Court in its Arthur Young decision determines that a showing of particularized need is required for the Service to obtain tax accrual work papers, such a requirement should not be limited merely to corporations who have reporting responsibility under the Exchange Act. It is the integrity of the independent auditing process as relied upon by investors, lenders, and those consummating commercial transactions that deserves consideration and preservation by this Court.

CONCLUSION

The decision below is clearly in conflict with the Second Circuit's opinion in Arthur Young, which is under review by this Court. Additionally, this case presents for the Court's consideration the public interest involved in preserving the integrity of the independent auditing process.

A writ of certiorari should, therefore, be granted to review, and ultimately reverse, the decision below in accordance with the Court's decision in Arthur Young.

Respectfully submitted,

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APPENDIX

APPENDIX A

In the Matter of The Tax Liability of Willis H. NEWTON, Lee M. Newton and Trio Manufacturing Company, Intervenors-Appellants,

UNITED STATES of America, and Douglas P. McCallum, special agent, Internal Revenue Service, Plaintiffs-Appellees,

v.

George B. PENNINGTON, CPA, Defendant.

UNITED STATES of America and Douglas P. McCallum, Special Agent, IRS, Plaintiffs-Appellants,

v.

George B. Pennington, CPA, Defendant-Appellee.

Nos. 82-8586, 83-8056.

United States Court of Appeals, Eleventh Circuit.

Nov. 3, 1983

Appeals from the United States District Court for the Northern District of Georgia.

Before JOHNSON and HENDERSON, Circuit Judges, and ALLGOOD,* District Judge.

*Honorable Clarence W. Allgood, U.S. District Judge for the Northern District of Alabama, sitting by designation.

JOHNSON, Circuit Judge:

These consolidated appeals present the question whether tax accrual workpapers prepared by an independent auditor of a closely held corporation may be subject to summons by the Internal Revenue Service ("IRS") without special showing of particularized need for the material sought. We hold that tax accrual workpapers are subject to IRS summons without any special showing and, accordingly, we affirm the order enforcing the summons in this case. We also affirm the denial of the government's motion to hold respondent Pennington in contempt for his refusal to comply with that part of the district court order that this Court stayed pending appeal.

The facts of this case are undisputed. The IRS commenced an audit of the 1977-79 federal income tax

returns of the closely held Trio Manufacturing Company ("Trio" or "Taxpayer") and of Willis H. Newton, a major shareholder of the family-owned company, and his wife. During the course of its investigation, the IRS, acting under the authority of 26 U.S.C.A. § 7602,[1/] issued two

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[1/] Section 7602 provides in relevant part:

> § 7602. Examination of books and witnesses (a) Authority to summon, etc.--For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, the Secretary or his delegate is authorized--
>
> (1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry;

(Footnote Continued on Next Page)

summonses to George B. Pennington, the certified public accountant retained by the Newtons to prepare their personal income tax returns and the corporate income tax returns of Trio, and to

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1/ (Footnote Continued from Previous Page)

> (2) To summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the Secretary or his delegate may deem proper, to appear before the Secretary or his delegate at a time and place named in the summons and to produce such books, papers, records, or other data, and to give such testimony, under oath, as may be relevant or material to such inquiry; and
> (3) To take such testimony of the person concerned under oath, as may be relevant or material to such inquiry.

26 U.S.C.A. § 7602.

conduct audits of Trio for the years 1977, 1978 and 1979.[2] The summons here in dispute sought information regarding Trio's tax liability, including any and all workpapers, analyses and computations prepared in the course of Pennington's annual audits of Trio.

In accordance with Taxpayer's directions, Pennington refused to comply with the summons, and the IRS petitioned the district court for an order enforcing its summons.[3] Pennington

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[2] The preparation of audited financial statements by a certified public accountant was required by banks from whom Trio obtained credit.

[3] The IRS enforcement action was premised on § 7604(b) of the Internal Revenue Code.

> (b) Enforcement.--Whenever any person summoned under section 6420(e)(2), 6421(f)(2), 6427(h)(2), or 7602 neglects or refuses to obey

(Footnote Continued on Next Page)

informed the court that he would comply with any order that it might enter and

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3/ (Footnote Continued from Previous Page)

> such summons, or to produce books, papers, records, or other data, or to give testimony, as required, the Secretary may apply to the judge of the district court or to a United States commissioner for the district within which the person so summoned resides or is found for an attachment against him as for a contempt. It shall be the duty of the judge or commissioner to hear the application, and, if satisfactory proof is made, to issue an attachment, directed to some proper officer, for the arrest of such person, and upon his being brought before him to proceed to a hearing of the case; and upon such hearing the judge or the United States commissioner shall have power to make such order as he shall deem proper, not inconsistent with the law for the punishment of contempts, to enforce obedience to the requirements of the summons and to punish such person for his default or disobedience.

26 U.S.C.A. § 7604(b). The jurisdiction of the district court was premised on §§ 7402(b) and 7604(a) of the Code.

(Footnote Continued on Next Page)

that his refusal to produce the summoned documents was only in deference to Taxpayer's directions. Taxpayer

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1/ (Footnote Continued from Previous Page)

> § 7402. (b) To enforce summons.--If any person is summoned under the internal revenue laws to appear, to testify, or to produce books, papers, or other data, the district court of the United States for the district in which such person resides or may be found shall have jurisdiction by appropriate process to compel such attendance, testimony, or production of books, papers, or other data.

26 U.S.C.A. § 7402(b).

> § 7604. Enforcement of summons
>
> (a) Jurisdiction of district court.--If any person is summoned under the internal revenue laws to appear, to testify, or to produce books, papers, records, or other data, the United States district court for the district in which such person resides or is found shall have jurisdiction by appropriate process to compel such attendance, testimony, or production of books, papers, records or other data.

26 U.S.C.A. § 7604(a).

successfully moved to intervene in the enforcement action.[4/]

The district court referred the case to a magistrate. After an evidentiary hearing and briefing by the parties, the magistrate recommended that the summons be enforced in its entirety. The district court adopted the magistrate's report and recommendation.

Taxpayer appealed, and this Court, after initially denying Taxpayer's motion for a stay of the enforcement order, granted a partial stay of the order with respect to the tax accrual workpapers sought by the IRS.

[4/] Section 7609(b) of the Internal Revenue Code permits intervention in a third-party summons proceeding by the real party in interest. 26 U.S.C.A. § 7609(b).

Pennington then produced all of the summoned materials except those that the Taxpayer asserted fell within this Court's stay, which after negotiations included some twenty-one pages of documents.

The government, disputing that tax accrual workpapers are beyond the scope of IRS summons authority and disputing that the documents withheld even constitute tax accrual workpapers, filed a motion in district court seeking to have Pennington held in contempt. The district court, considering this Court's partial stay, conducted an in camera review of the disputed documents, determined that they were tax accrual workpapers and denied the government's contempt motion.

Trio appeals the district court's order enforcing the IRS summons as to

tax accrual workpapers. The government appeals the district court's denial of its contempt motion. We will consider these consolidated appeals in turn.

I. TAXPAYER'S APPEAL.

Trio argues that this Circuit should follow the decision of the Second Circuit in United States v. Arthur Young & Company, 677 F.2d 211 (2d Cir.1982), cert. granted, _____ U.S. _____, 103 S.Ct. 1180, 75 L.Ed.2d 429 (1983), and hold that an accountant work product privilege protects tax accrual workpapers from IRS summons power absent a showing of particularized need and inability to obtain the substantial equivalent from other sources. Trio further argues that no such showing has been made here.

Trio also argues that the district court erred as a matter of law in concluding that Pennington's tax accrual workpapers are relevant to the amount of Taxpayer's federal income tax liability. Trio argues that tax accrual workpapers are not relevant per se to an IRS investigation of Taxpayer's correct tax liability. Trio further argues that the relevancy of the documents to the IRS investigation cannot be determined simply from the description of the documents in the IRS summons, but that the Service must make a further showing of relevancy after the Taxpayer presents some contrary evidence. Trio contends that the IRS failed to make this showing.

Preliminarily, we must address the government's contention that the question whether tax accrual workpapers are protected from IRS summons power is

not properly before this Court because it was not adequately raised below. This contention is without merit. As we have recently noted, "[t]he law is clear that, absent special circumstances, defenses not presented and for which proof is not offered in the trial court cannot be raised for the first time on appeal." Johnson v. Smith, 696 F.2d 1334, 1338 (11th Cir.1983). The record in this case clearly indicates that Trio raised the tax accrual issue in the district court, even if it did not concentrate on that issue in its defense. Moreover, it appears that the reason Taxpayer did not emphasize the issue is that the government never specified that it was seeking "tax accrual" documents.

The broad language of the summons sought any and all workpapers, analyses and computations prepared in the course

of Pennington's audits of Trio. Taxpayer sought to clarify the scope of the summons through subpoenas of IRS agents and documents and supported its position with the argument that the government must make a showing of particularized need for workpapers and analyses prepared during a financial audit. The government successfully moved to quash Taxpayer's subpoenas. At the evidentiary hearing, Taxpayer attempted to discover whether the Service sought tax accrual workpapers by directly asking the agent who drafted the summons. The agent responded that he was unfamiliar with such documents. Finally, in the Taxpayer's proposed findings of fact and conclusions of law submitted to the magistrate and in its objections to the magistrate's report, Taxpayer cited Arthur Young and argued

that tax accrual workpapers could not be subject to IRS summons merely on a showing of their relevancy to a tax investigation. In view of these facts, we hold that Taxpayer adequately presented this defense to the trial court, and this Court may consider the issue on appeal.

A. Whether tax accrual workpapers are relevant.

The Internal Revenue Service has broad authority under Section 7602. The Service may examine "any books, papers, records or other data which may be relevant or material" to its investigation of the correctness of any tax return. 26 U.S.C.A. § 7602(a). The Supreme Court in United States v. Powell, 379 U.S. 48, 85 S.Ct. 248, 13 L.Ed.2d 112 (1964), defined the minimal showing that the IRS must make when

seeking an order to enforce its summons. Id. at 57-58, 85 S.Ct. at 255. It must show that

> the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to that purpose, that the information sought is not already within the Commissioner's possession, and that the administrative steps required by the Code have been followed . . .

Id.

The Service can satisfy its burden merely by presenting the sworn affidavit of the agent who issued the summons. United States v. Southeast First National Bank of Miami Springs, 655 F.2d 661, 664 (5th Cir.1981).[5/] Once the

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[5/] The Eleventh Circuit Court of Appeals has adopted the case law of the former Fifth Circuit handed down as of September 30, 1981, as its governing body of precedent, which is binding unless and until overruled or modified by this Court en banc. Bonner v. City of Prichard, 661 F.2d 1206, 1209 (11th Cir.1981) (en banc.).

government makes this minimal showing, the burden shifts to the taxpayer to disprove one of the elements of the government's case or to show that enforcement of the summons would be an abuse of the court's process. Id.; United States v. Davis, 636 F.2d 1028, 1034 (5th Cir.1981).

Taxpayer here argues that the Service carries the ultimate burden in a summons enforcement proceeding. If the taxpayer presents some evidence that the government has not satisfied the Powell requirements or that enforcement otherwise would be an abuse of process, then the government must come forward with ultimately persuasive evidence. Trio argues that, after it presented evidence challenging the relevancy of the tax accrual workpapers to the IRS tax investigation, the government was

required to persuade the court that the workpapers were relevant to its investigation.

Because we determine that the IRS here made the minimal showing as required by Powell and that tax accrual workpapers are relevant as a matter of law to a legitimate investigation of a corporation's correct tax liability, we find it unnecessary to discuss further the burdens of proof required in a summons enforcement proceeding.

Due to the complexity of the federal tax structure, the return filed by a corporate taxpayer often is not the final statement of the amount of taxes owed. Taxpayers often are required to pay more in taxes than their returns indicated. Many corporation, therefore, set aside a reserve on their balance sheets to cover this potential additional

liability. Corporate financial statements that do not include a reserve for contingent tax liability may give an inaccurate picture of the firm's financial position. Consequently, as Trio itself noted, generally accepted auditing principles require auditors to assess a corporation's contingent tax liability and determine whether it is great enough to require the corporation to reveal the potential liability on its balance sheet. In addition, federal securities laws require regulated corporations to file with the Securities and Exchange Commission financial statements that have been audited by independent accountants in accordance with generally accepted auditing principles.[6/] The documents generated

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[6/] 15 U.S.C.A. § 781; 17 C.F.R. § 210.1-02(d).

by that tax accrual analysis disclose the weak spots in the corporation's assessment of its own tax liability.

In United States v. Wyatt, 637 F.2d 293 (5th Cir.1981), the former Fifth Circuit, in a decision that is binding on this Court, articulated the test for relevancy under Powell. The test is "whether the summons seeks information which 'might throw light upon the correctness of the taxpayer's return'" and, more narrowly, whether there is "an indication of a 'realistic expectation rather than an idle hope that something might be discovered.'" Id. at 300-01 (citations omitted).

The Fifth Circuit, applying this test in a nonbinding decision, recently held that tax accrual workpapers are relevant to a determination of a

corporation's tax liability. United States v. El Paso Company, 682 F.2d 530, 537 (5th Cir.1982). The court there rejected the suggestion that tax accrual workpapers are not relevant because they are neither tools used to prepare tax returns nor source documents representative of actual transactions. Id. The court thus squarely rejected the reasoning of United States v. Coopers & Lybrand, 550 F.2d 615 (10th Cir.1977), which denied the relevancy of tax accrual workpapers to an IRS investigation. Id. at 621.

Applying the Wyatt definition, we agree that tax accrual workpapers are relevant. The workpapers highlight and assess questionable tax interpretations that the taxpayer has given to its transactions. As the Arthur Young court itself noted in holding tax accrual

workpapers relevant to a legitimate IRS investigation, "[d]ifferent tax positions lead to different amounts of liability. It is difficult to say that the assessment by the independent auditor of the correctness of the positions taken by the taxpayer in his return would not throw 'light upon' the the correctness of the return." 677 F.2d 211, 219 (2d Cir.1982), cert. granted, _____ U.S. _____, 103 S.Ct. 1180, 75 L.Ed.2d 429 (1983).[1/] Moreover, the controlling precedent of this Circuit does not require that information relevant to a tax

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[1/] The Second Circuit, while holding that tax accrual workpapers are relevant to a legitimate IRS investigation, also held that they are protected from IRS summons by an accountant work product privilege that can be overcome only upon a showing of a particularized need. 677 F.2d at 220-21.

investigation be limited to source documents or materials used in preparing returns. See, e.g., United States v. Wyatt, 637 F.2d 293 (5th Cir.1981) (summons sought corporate officials' answers to specific questions regarding their knowledge of bribes, kickbacks and other illegal transactions); United States v. Newman, 441 F.2d 165 (5th Cir.1971) (summons sought records of taxpayer's business associates). We thus join the Second and Fifth Circuits in rejecting the Tenth Circuit's holding in Coopers & Lybrand.

B. Whether tax accrual workpapers are privileged.

Taxpayer argues that, even if relevant, tax accrual workpapers should not be subject to IRS summons authority absent a showing of particularized need. Taxpayer asks this Court to adopt

and extend the reasoning of the Second Circuit in United States v. Arthur Young Company, 677 F.2d 211 (2d Cir.1982), cert. granted, _____ U.S. _____, 103 S.Ct. 1180, 75 L.Ed.2d 429 (1983), which held that tax accrual workpapers prepared by independent auditors of a public corporation subject to the federal securities laws are protected from IRS summons authority by a work product privilege similar to the attorney work product privilege recognized by the Supreme Court in Hickman v. Taylor, 329 U.S. 495, 67 S.Ct. 385, 91 L.Ed. 451 (1947), and embodied in Rule 26 of the Federal Rules of Civil Procedure.

The decision of the Second Circuit in Arthur Young is based on a perceived conflict between the federal tax and securities laws. The court observed

that a decision to permit the IRS routinely to summon documents that contain an auditor's assessment of the questionable tax position taken by its client would undermine the integrity of the auditing process and defeat the purpose of the securities laws mandating independent financial audits and public filing of financial statements. 677 F.2d at 219-20. The court assumed that corporate officials would be less forthcoming with an independent auditor once they knew that the auditor's assessment of the corporation's contingent tax liability would be readily accessible to Internal Revenue agents. Id. at 220. Faced with this "clash between two important congressional policies," id., and cognizant of the Supreme Court's recognition that "'contrary legislative

purposes' can undercut the 'broad latitude' otherwise provided to the IRS," id. at 219 (quoting United States v. Euge, 444 U.S. 707, 716 & n. 9, 100 S.Ct. 874, 880 & n. 9, 63 L.Ed.2d 141 (1980)), the Second Circuit carved out of the IRS summons authority a new accountant work product privilege. The court stated that the new privilege, similar to the attorney work product privilege, allows "the IRS to procure [tax accrual workpapers] when the rare situation arises when it can make a sufficient showing of need to adequately justify invading the integrity of the auditing process." Id. at 221.

Trio argues that this Court should adopt the reasoning of Arthur Young and extend it to a case that does not present the same conflict between congressional purposes--because it

involves a closely held corporation that is not subject to the federal securities laws--but that does implicate similar policy concerns. We decline this invitation to follow the Second Circuit and embrace instead the position taken by Judge Newman in dissent. We also note the Fifth Circuit's recent decision in United States v. El Paso Company, 682 F.2d 530 (5th Cir.1982), which supports our decision in this case.

The broad summons authority that Congress gave to the Internal Revenue Service under Section 7602 is subject to the "'traditional privileges and limitations.'" Upjohn Company v. United States, 449 U.S. 383, 398, 101 S.Ct. 677, 687, 66 L.Ed.2d 584 (1981). The Supreme Court has held, for example, that the attorney-client privilege and the attorney work product doctrine limit

the scope of the IRS summons power. Id. at 386, 101 S.Ct. at 681. Federal law, however, does not recognize an accountant-client privilege, Couch v. United States, 409 U.S. 322, 335, 93 S.Ct. 611, 619, 34 L.Ed.2d 548 (1973); International Horizons, Inc. v. Committee of Unsecured Creditors, 689 F.2d 996, 1003-04 (11th Cir.1982), or, at least before Arthur Young itself, an accountant work product privilege, United States v. Arthur Young Company, 677 F.2d at 222 (Newman, J., dissenting).[1/]

[1/] Despite extensive and recent precedent explicitly rejecting the existence of an accountant-client privilege under federal common law, the Second Circuit's decision essentially creates just such a privilege. Although the court labels its creation an accountant work product privilege, the policy rationale it relied upon to support its new doctrine--encouraging

(Footnote Continued on Next Page)

Congress' explicit grant of summons power to the IRS should not be limited by a newly recognized privilege unless Congress itself chooses to so limit IRS authority. The Supreme Court in its review of IRS summons power has made clear that "absent unambiguous directions from Congress," the courts should not impose additional restrictions on the scope of Section 7602. United States v. Bisceglia, 420

1/ (Footnote Continued from Previous Page)

corporate officials to reveal openly to their independent accountants the corporation's tax vulnerabilities--argues for an accountant-client communications privilege to be exercised by the client rather than an accountant work product doctrine to protect the accountant's independent assessment of the amount of tax that the corporation owes to the federal fisc. See United States v. El Paso Company, 682 F.2d 530, 541 n. 13 (5th Cir.1982); Arthur Young, 677 F.2d at 223, n. 5 (Newman, J., dissenting).

U.S. 141, 150, 95 S.Ct. 915, 921, 43 L.Ed.2d 88 (1975).

Trio is not subject to the same federal securities laws that were deemed critical to the decision in Arthur Young, but it argues that the same policy there embraced--protection of accountant work product to ensure the integrity of the auditing process and the protection of investor confidence--should be adopted here. In view of our determination that Congress is the proper body to make any decision to limit IRS summons power with newly recognized privileges, and especially in the absence of any conflicting congressional purposes, we refuse to adopt the position urged upon us by the Taxpayer.

II. GOVERNMENT'S APPEAL.

The government appeals the district court's denial of its motion to hold Pennington in contempt for his failure to produce twenty-one documents within the scope of the court's summons enforcement order. The government notes that use of the contempt motion was procedurally necessary to bring before this Court the tax accrual workpapers issue, but concedes that imposition of sanctions to obtain those records may be unnecessary. We agree.

This Court granted a stay of the district court's summons enforcement order with respect to tax accrual workpapers within the doctrine of Arthur Young. In granting the partial stay, we noted that, if the parties could not agree on what was required to be produced under the IRS summons, their

dispute could be adjudicated by the district court in a contempt proceeding. Throughout the entire course of this litigation, respondent Pennington has repeatedly made clear his willingness to comply with any court order, including any order issuing from the contempt proceeding.

The standard of review on appeal from a grant or denial of a civil contempt motion is whether the district court abused its discretion. Washington-Baltimore Newspaper Guild, Local 35 v. Washington Post Co., 626 F.2d 1029, 1031 (D.C.Cir.1980); cf. United States v. Brummitt, 665 F.2d 521, 526 (5th Cir.1981), cert. denied, 456 U.S. 977, 102 S.Ct. 2244, 72 L.Ed.2d 852 (1982) (criminal contempt). The standard requires the petitioner in a civil contempt case to prove by clear

and convincing evidence that the respondent violated the court's prior order. 626 F.2d at 1031; see Northside Realty Associates, Inc. v. United States, 605 F.2d 1348, 1352 (5th Cir. 1979).

The government argued before the district court, and it repeats its argument here, that no tax accrual workpapers within the doctrine of Arthur Young exist in this case because Trio is a closely held corporation and because its balance sheet does not contain a reserve for contingent tax liability. In its November 19, 1982, memorandum decision denying the contempt motion, the district court noted that Arthur Young may not apply to this case, but on the basis of this Court's partial stay correctly decided to assume applicability of the doctrine until this Court could decide the question.

The government also argued that the district court did not have a sufficient factual basis for determining that the documents withheld from the IRS were tax accrual workpapers. The government first points out that Pennington himself did not testify that the documents withheld were tax accrual workpapers or even that his audit of Trio included an analysis of its contingent tax liability. The government then simply argues that in camera inspection of the documents cannot reveal whether they reflect such analysis.

Pennington's failure to testify is not probative on the question whether the documents withheld were tax accrual workpapers because Pennington throughout the course of these proceedings has sought to maintain his neutrality. Furthermore, the court had before it

evidence that Pennington's financial audit reports were prepared in accordance with generally accepted auditing principles, which require the auditor to review with management the question whether any contingent liabilities exist. Finally, under the circumstances of this case, in camera inspection of the disputed documents seems to be the only feasible means of determining whether the documents are tax accrual workpapers without revealing to the IRS the contents of the materials sought to be protected.

In view of this Court's partial stay of the summons enforcement order, the district court did not abuse its discretion in denying the government's contempt motion.

Accordingly, we AFFIRM the order enforcing the IRS summons, and we AFFIRM the denial of the government's contempt motion.

APPENDIX B

UNITED STATES COURT OF APPEALS
For The Eleventh Circuit

No. 82-8586
83-8056

D.C. Docket No. C82-1138A & C82-1139A

In the Matter of the Tax Liability of Willis H. NEWTON, Lee M. Newton and Trio Manufacturing Company, Intervenors-Appellants,

UNITED STATES of America, and Douglas P. McCallum, special agent, Internal Revenue Service, Plaintiffs-Appellees,

v.

George B. PENNINGTON, CPA,
Defendant.

UNITED STATES of America and Douglas P. McCallum, Special Agent, IRS,
Plaintiffs-Appellants,

v.

George B. PENNINGTON, CPA,
Defendant-Appellee.

Appeals from the United States District Court for the Northern District of Georgia.

Before JOHNSON and HENDERSON, Circuit Judges, and ALLGOOD*, District Judge.

J U D G M E N T

This cause came on to be heard on the transcript of the record from the United States District court for the Northern District of Georgia, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the order of the District Court appealed from, in this cause be, and the same is hereby, AFFIRMED;

It is further ordered that each party bear their own costs on appeal to be taxed by the Clerk of this Court.

November 3, 1983

*Honorable Clarence W. Allgood, U.S. District Judge for the Northern District of Alabama, sitting by designation.

ISSUED AS MANDATE:

NO. 83-1024

In The

Supreme Court of the United States

October Term, 1983

Trio Manufacturing Company,
Petitioner,

vs.

United States of America,
Respondent.

On Certiorari To The United States Court of Appeals For The Eleventh Circuit

SUPPLEMENTAL APPENDIX

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January 3, 1984

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IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF GEORGIA
ATLANTA DIVISION

UNITED STATES OF AMERICA, and DOUGLAS P. McCALLUM, Special Agent, Internal Revenue Service,	)	No. C82-1138 & C82-1139
Petitioners,	)	
vs.	)	ORDER FOR SERVICE OF REPORT AND RECOMMENDATION OF UNITED STATES MAGISTRATE
GEORGE B. PENNINGTON, CPA,	)	
Respondent,	)	
WILLIS H. NEWTON, LEE M. NEWTON and TRIO MANUFACTURING COMPANY,	)	
Intervenors	)	

Attached is the report and recommendation of the United States Magistrate made in this action in accordance with 28 U.S.C. § 636(b)(1) and this Court's Local Rule 290. Let

the same be filed and a copy, together with a copy of this Order, be served upon counsel for the parties.

Pursuant to 28 U.S.C. § 636(b)(1), each party may file written objections, if any, to the report and recommendation within ten (10) days of the receipt of this Order. Should objections be filed, they shall specify with particularity the alleged error or errors made (including reference by page number to the transcript if applicable) and shall be served upon the opposing party. The party filing objections will be responsible for obtaining and filing the transcript of any evidentiary hearing for review by the District Court. If no objections are filed, the report and recommendation may be adopted as the

Opinion and Order of the District Court and any appellate review of factual findings will be limited to a plain error review. See Nettles v. Wainwright, ___ F.2d ___ Slip op. p. 15152 (5th Cir. 1982) (Unit B en banc).

The Clerk is directed to submit the report and recommendation with objections, if any, to the District Court after expiration of the above time period.

AND IT IS SO ORDERED this 27th day of July, 1982.

Signed/Robert J. Castellani
UNITED STATES MAGISTRATE

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF GEORGIA
ATLANTA DIVISION

UNITED STATES OF AMERICA, and DOUGLAS P. McCALLUM, Special Agent, Internal Revenue Service,	)	No. C82-1138A & C82-1139A
Petitioners,	)	
vs.	)	
GEORGE B. PENNINGTON, CPA,	)	
Respondent,	)	
WILLIS H. NEWTON, LEE M. NEWTON and TRIO MANUFACTURING COMPANY,	)	
Intervenors	)	

MAGISTRATE'S REPORT AND RECOMMENDATION

These two cases are before the magistrate on the petitions to judicially enforce Internal Revenue summonses pursuant to 26 U.S.C.

§ § 7402(b) 7604(a). The two cases are hereby consolidated under rule 42(a), F.R.Civ.P. Pursuant to notice a consolidated adversary hearing was held on June 29, 1982. After considering the evidence submitted at that hearing and the legal arguments of petitioners and intervenors, the magistrate recommends the following findings of fact and conclusions of law.

Findings of Fact

1. On April 7, 1981, petitioners (hereafter IRS) served two summonses upon respondent directing him to testify and produce certain books, records and other data described in the summonses. Petitioner Douglas P. McCallum is a Special Agent employed by the IRS and is authorized to issue Internal Revenue

summonses. The respondent is a certified public accountant. Intervenors are Willis H. Newton, Lee M. Newton and Trio Manufacturing Company (hereafter taxpayers). The summoned documents related to the income tax liability of taxpayers for the years 1977, 1978 and 1979.

2. Taxpayers stayed compliance with the summonses pursuant to 26 U.S.C. §7609(b) and respondent has not complied with the summons.

3. The IRS is examining the taxpayers to determine whether they have any additional tax liability for the years in question and whether they have violated the criminal law relating to payment of tax.

4. During his investigation of the corporate taxpayer, Revenue Agent Misinco [1], on or about December 10, 1980, discovered several invoices or paid expense invoices that appeared to be altered. Although his discovery made him suspicious and caused him to investigate further, he did not obtain a firm indication of fraud until approximately January 23, 1981. Within approximately 45 days after his initial discovery, and after conversations with his supervisor and further review of the

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[1] A revenue agent only determines civil tax liability whereas a special agent also investigates the possibility of recommending criminal charges against the taxpayer. United States v. Toussaint, 456 F. Supp. 1069 (S.D.Tex. 1978).

corporate taxpayer's records, Revenue Agent Misinco decided on or about January 23, 1981, to submit the case for referral to IRS Criminal Investigation Division as a possible criminal fraud case. The case was accepted for referral shortly thereafter.

5. The case's current status is a joint criminal and civil investigation. The special agent in charge of the investigation has not yet decided whether to initiate a referral of the case to the Department of Justice for criminal prosecution. According to his testimony, he cannot make this decision until he has reviewed the data and testimony sought by this summons. The only contact by the special agent or his supervisor with the Department of

Justice about this case concern this request for summons enforcement. No official of the IRS has decided whether to refer this case to the Department of Justice for criminal prosecution.

6. Although the IRS has seen certain documents and data which were in the taxpayers' possession, it has not reviewed or copied any of the requested documents in respondent's possession or heard the testimony of the respondent in this case.

7. All administrative steps required by the Internal Revenue Code for issuance of the summonses have been taken.

Conclusions of Law

8. This court has jurisdiction of this matter under 26 U.S.C. § § 7402, 7604.

9. Taxpayers have intervened timely and are proper parties to this proceeding.

10. The IRS need not meet any standard of probable cause to obtain enforcement of its summonses. It need only make a preliminary showing

> that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already within the Commissioner's possession, and that the administrative steps required by the code have been follows. . . .

United States v. Powell, 379 U.S. 48, 57-58 (1964), quoted with approval in United States v. Southeast First National Bank, 655 F.2d 661, 664 (5th Cir. 1981).

11. The IRS can make this prima facie case for enforcement by introducing the sworn affidavit of the agent who issued the summons. United States v. Southeast First National Bank, 655 F.2d 661, 664 (5th Cir. 1981). Once the IRS makes this minimal showing, the burden shifts to the taxpayer to come forward with rebutting evidence. Id.

12. The summonses here were not issued solely to gather information for a criminal investigation. The Supreme Court and the Fifth Circuit Court of Appeals have decided that a summons issued before the IRS makes a formal recommendation of criminal prosecution to the Department of Justice is invalid only if the IRS has abandoned, in an institutional sense, the pursuit of

immediate civil tax collection. United States v. LaSalle National Bank, 437 U.S. 298 (1978); United States v. Davis, 636 F.2d 1028 (5th Cir. 1981); United States v. Harris, 628 F.2d 875 (5th Cir. 1980). Since the decision to refer usually takes place in the upper echelons of the IRS hierarchy after several layers of review, such an institutional abandonment would require an extraordinary departure from established procedures. United States v. LaSalle National Bank, supra, 437 U.S. at 314. The Fifth Circuit Court of Appeals has therefore recognized that before the investigating agent completes his investigation or makes a recommendation for criminal prosecution, summonses are "virtually unassailable".

United States v. Harris, 628 F.2d 875, 882 (5th Cir. 1980). The taxpayers have introduced no evidence which could overcome their high hurdle on this issue.

13. The information sought is not already within the IRS' possession. One of the primary reasons for seeking this information from respondent is the taxpayers' suspected fraud. The IRS admits it has seen some information comparable to that requested when it reviewed the taxpayers' records. But, the IRS makes a very persuasive argument that it wishes to verify the accuracy of the data by comparing what it has already seen to what the taxpayers furnished to their accountant. The IRS need not prove probable cause before it investigates a taxpayer. It can seek

information merely on suspicion that the law is being violated, or even just because it wants assurance that it is not. United States v. Wyatt, 637 F.2d 293, 299 fn. 9 (5th Cir. 1981).

Further, much of what the IRS seeks from the respondent is not in IRS' possession. Also, it has not received or reviewed any information from the respondent. No one has claimed that the possibly duplicative material is bulky or burdensome to produce. The "already possessed" rule is better suited for cases such as United States v. Pritchard, 438 F.2d 969 (5th Cir. 1971), where an agent had informally examined the taxpayer's records at length and later sought to compel their production without any explanation of why the

informal examination was insufficient. See United States v. Davis, 636 F.2d 1028, 1038 (5th Cir. 1981).

14. The test of relevancy in a summons enforcement case is whether the summons seeks information which might throw light on the correctness of the taxpayer's return. United States v. Wyatt, 637 F.2d 293 (5th Cir. 1981). In this case, the relevancy of the requested documents is abundantly clear from the description of the documents in the summonses.

15. The IRS did not fail to follow the administrative steps necessary to secure enforcement of the summonses. As noted in finding of fact 4 above, the magistrate believes that the revenue agent referred the

investigation to IRS Criminal Investigation Division when he had assured himself he had sufficient indications of fraud. In any event, the magistrate doubts that the defect asserted by taxpayers, even if proved, would invalidate the summonses. See United States v. Bank of Moulton, 614 F.2d 1063, 1066 (5th Cir. 1980); United States v. Lockyer, 448 F.2d 417 (10th Cir. 1971).

16. The summons is not overbroad. United States v. Wyatt, 637 F.2d 293 (5th Cir. 1981).

RECOMMENDATION

Taxpayers have filed motions for discovery of materials beyond those already produced at the adversary hearing. At that hearing taxpayers

failed to raise any colorable question as to the good faith of the IRS in this proceeding. Any further discovery would be a waste of time and an unnecessary delay to the enforcement of the summonses. United States v. Davis, 636 F.2d 1028, 1038, (5th Cir. 1981). the magistrate recommends that any further discovery be denied.

For the above reasons, the magistrate recommends that the summonses be enforced as provided by law. The respondent should be required to testify and produce the designated records before Special Agent McCallum or any other proper officer of the Internal Revenue Service within fifteen (15) days after the entry of any order approving this report and recommendation, at a

reasonable time and place to be determined by Special AGent McCallum or any other proper officer. The magistrate further recommends that petitioners recover from intervenors-taxpayers their costs in bringing these actions.

SO RECOMMENDED this 27th day of July, 1982.

Signed/Robert J. Castellani
ROBERT J. CASTELLANI
UNITED STATES MAGISTRATE

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF GEORGIA
ATLANTA DIVISION

UNITED STATES OF AMERICA, and DOUGLAS P. McCALLUM, SPECIAL AGENT, INTERNAL REVENUE SERVICE,	)	CIVIL ACTION NOs.: C82-1138 A & C82-1139
Petitioners,	)	
vs.	)	
GEORGE B. PENNINGTON, CPA,	)	
Respondent.	)	

O R D E R

After having carefully reviewed the record, the transcript and the Magistrate's Report and Recommendation in this case, the Magistrate's report and Recommendation is received with approval and adopted as the opinion and order of the court.

So ORDERED this 31st day of August, 1982.

Signed/Robert H. Hall
ROBERT H. HALL
UNITED STATES DISTRICT JUDGE

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF GEORGIA
ATLANTA DIVISION

UNITED STATES OF AMERICA, and DOUGLAS P. McCALLUM, Special Agent, Internal Revenue Service,	)	CIVIL ACTION NO. C82-1133A
Petitioners,	)	
vs.	)	CIVIL ACTION NO. C82-1139A
GEORGE B. PENNINGTON, CPA,	)	
Respondent.	)	
In the matter of the Tax Liability of Willis H. Newton, Lee M. Newton and Trio Manufacturing Company.	)	

O R D E R

Petitioners filed a motion for contempt against Respondent, George B. Pennington, to require him to show cause why he should not be held in contempt of

this court's order of September 23, 1982 enforcing two Internal Revenue Service summonses. That order was appealed to the Eleventh Circuit Court of Appeals. Both courts initially denied a stay of this court's order, but on October 7, 1982, on motion for reconsideration, the Eleventh Circuit entered a stay ". . . with respect to tax accrual workpapers within the doctrine of United States v. Young, 677 F.2d 211 (2d Cir. 1982)." On further consideration, the Eleventh Circuit made no change in its October 7 order.

The documents sought by Petitioners in the motion for contempt consist of twenty-one (21) pages. These documents have been submitted to the court for an in camera inspection.

Petitoners contend that the taxpayer, Trio Manufacturing Company, is a closely-held family corporation and therefore does not fall within the doctrine of United States v. Young, supra. This argument has considerable merit since the papers in question in Young were prepared for a public corporation required by the federal securities laws to file a financial statement of its potential liabilities. The limited privilege for the accountant's tax accrual workpapers recognized in Young seems to have been born from the collision the court perceived between the interest in the collection of revenues and the promotion of full disclosure under the securities laws.

However, the court must reject the argument that the Young privilege does not apply to a company not subject to the disclosure requirements of the federal securities laws. If the Eleventh Circuit believed Young to be inapplicable or even altogether unwise, there would have been no reason to have entered a stay. At the very least, the Eleventh Circuit apparently felt a stay was necessary to protect the taxpayer until it could thoroughly examine the doctrine of Young. In these circumstances, and without clearer direction from the court above, this court must assume Young applies for purposes of determining what papers are subject to the stay.

The government argues alternatively that even if Young applies, the papers in question here are not tax accrual workpapers because none of the financial statements of Trio Manufacturing Company disclose contingent tax liabilities. Tax accrual workpapers reflecting subjective discussions and opinions concerning contingent tax liabilities, the government argues, cannot exist in the absence of such a contingency.

Even though this argument has considerable merit as well, this court cannot accept it in view of the definition of tax accrual workpapers set out in Young. That court stated that "[t]hese documents are generated when an auditor verifies whether the taxpayer

has accurately determined its contingent tax liability." 677 F.2d at 217. It seems to this court that the same process would take place and papers reflecting subjective impressions generated when the conclusion is that there is no contingent tax liability as when a contingency is determined to exist. Young, in any event, indicates no such distinction.

With the above premises established, the court finds that the twenty-one pages are tax accrual workpapers prepared by an independent auditor in verifying whether the taxpayer has accurately determined its contingent tax liability. They therefore come within the stay granted by the Court of Appeals. The

Petitioners' motion for contempt against the Respondent is DENIED.

So ORDERED this 19th day of November, 1982

Signed/Robert H. Hall
ROBERT H. HALL
UNITED STATES DISTRICT JUDGE

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No. 83-1024

In the Supreme Court of the United States

OCTOBER TERM, 1983

TRIO MANUFACTURING COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether tax accrual workpapers, prepared by an independent auditor of a closely-held corporation not subject to reporting requirements under the federal securities laws, are privileged from disclosure in response to an IRS summons.

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In the Supreme Court of the United States

OCTOBER TERM, 1983

No. 83-1024

TRIO MANUFACTURING COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A35) is reported at 718 F.2d 1015. The opinion of the district court (Pet. App. C19-C20), adopting the report and recommendation of the magistrate (Pet. App. C1-C18), is not officially reported.

JURISDICTION

The judgment of the court of appeals (Pet. App. B1-B2) was entered on November 3, 1983. The petition for a writ of certiorari was filed on December 20, 1983. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Petitioner is a closely-held corporation, all of its stock being owned by members of the same family (Pet. App. A3). Because petitioner's shares are not publicly traded, it is not subject to reporting requirements under the federal securities laws (Pet. 5; Pet. App. A29). In 1981, the IRS began an audit of petitioner's 1977-1979 corporate income tax returns. Pursuant to that investigation, the Service issued summonses, under authority of Section 7602 of the Code,[1] to the certified public accountant retained by petitioner to prepare its tax returns and audit its financial statements (Pet. App. A4-A5).[2] (The preparation of audited financial statements by an independent accountant was required by the banks from which petitioner had borrowed money. *Id.* at A5 n.2.) The summonses directed the accountant to produce various documents relating to petitioner's 1977-1979 tax years, including 21 pages of "tax accrual workpapers," *i.e.*, workpapers drafted by the accountant in verifying whether petitioner had reserved a sufficient amount on its books to cover its contingent tax liabilities (*id.* at A5, C26).

The accountant refused to comply with the summonses insofar as they requested production of the tax accrual workpapers (Pet. App. A5-A9). The government petitioned for enforcement in the United States District Court for the Northern District of

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[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended (the Code or I.R.C.).

[2] Section 7602(a)(1) authorizes the Commissioner, "[f]or the purpose of ascertaining the correctness of any return, * * * [t]o examine any books, papers, records, or other data which may be relevant or material to such inquiry."

Georgia (*id.* at C4-C5; I.R.C. § 7604(b)), and petitioner intervened (I.R.C. § 7609(b)). The district court referred the case to a magistrate, and adopted the magistrate's report and recommendation that the summonses be enforced (Pet. App. C1-C20). It found that the summonses had been issued "in good faith" under the standards set forth in *United States* v. *Powell*, 379 U.S. 48, 57-58 (1964) (Pet. App. C10-C14), and that the requested information was "relevant" to the IRS investigation within the meaning of Section 7602 because it "might throw light on the correctness of [petitioner's] return[s]" (Pet. App. C15, citing *United States* v. *Wyatt*, 637 F.2d 293 (5th Cir. 1981)).

The court of appeals unanimously affirmed (Pet. App. A1-A35). It agreed that the tax accrual workpapers were "relevant," rejecting the reasoning of *United States* v. *Coopers & Lybrand*, 413 F. Supp. 942 (D. Colo. 1975), aff'd, 550 F.2d 615 (10th Cir. 1977), which on the facts there presented had denied the relevancy of such documents to an IRS investigation (Pet. App. A20-A22). And it refused to adopt and extend to this case the reasoning of the Second Circuit in *United States* v. *Arthur Young & Co.*, 677 F.2d 211 (1982), cert. granted, No. 82-687 (Feb. 22, 1983), which had concluded that tax accrual workpapers prepared by an independent auditor of a publicly-held corporation are protected by an accountant's work product privilege from disclosure in response to an IRS summons (Pet. App. A22-A29). The court of appeals held that *Arthur Young* was wrongly decided (Pet. App. A26-A28), and that the rationale of that case in any event did not apply to this one. The *Arthur Young* decision, it noted, was "based on a perceived conflict between the federal tax and securi-

ties laws" (Pet. App. A23), a conflict stemming from the fact that the taxpayer was subject to SEC reporting requirements, and from the Second Circuit's concern that IRS access to tax accrual workpapers "would undermine the integrity of the auditing process" to the detriment of the securities markets (*id.* at A24). The court of appeals distinguished *Arthur Young* on that basis, noting that petitioner here "is not subject to the same federal securities laws that were deemed critical to the decision in *Arthur Young*" (*id.* at A29), and holding that this case accordingly did not manifest a "clash between two important congressional policies" sufficient to justify a privilege even on the Second Circuit's reasoning (*id.* at A24).

ARGUMENT

1. The court of appeals correctly held that creation of a federal accountant's work product privilege is unjustifiable. As demonstrated in our brief in *Arthur Young*,[3] this Court and (with the exception of the Second Circuit) the lower federal courts have consistently held that "no confidential accountant-client privilege exists under federal law, and no state-created privilege has been recognized in federal cases." *Couch* v. *United States*, 409 U.S. 322, 335 (1973) (quoted in U.S. Br. at 11, *United States* v. *Arthur Young & Co.*, No. 82-687). These cases reflect the principle that only the weightiest reasons of public policy justify creation of privileges, which limit the admissibility of probative evidence and impair the search for truth (U.S. Br. at 15). The considerations militating against recognizing privileges generally, moreover, have special force when the privilege sought to be created would operate uniquely to obstruct com-

[3] Copies of our brief and reply brief in *Arthur Young* are being sent to petitioner's counsel.

pliance with IRS summonses. As noted below (Pet. App. A28-A29), this Court has held that the Commissioner's summons power should be broadly construed, and should not be restricted "absent unambiguous directions from Congress." *United States* v. *Bisceglia*, 420 U.S. 141, 150 (1975). Thus, for the reasons set forth in our *Arthur Young* brief, petitioner's effort to establish a federal accountant's privilege must be rejected. Accord, *United States* v. *El Paso Co.*, 682 F.2d 530 (5th Cir. 1982), petition for cert. pending, No. 82-716.

2. Regardless of whether *Arthur Young* was correctly decided, however, there is no merit to petitioner's contention (Pet. 15-16) that that decision conflicts with this one. As the court below observed, the rationale of *Arthur Young* has no application here. The summons in *Arthur Young* requested production of tax accrual workpapers prepared by an accountant in auditing the financial statements of a publicly-held corporation and in certifying the accuracy of those statements under the federal securities laws. As the Second Circuit saw the matter, "[t]he verification procedure envisioned by the [Securities] Act requires * * * that management feel free to cooperate with their auditors, and to disclose to them confidential information, such as the questionable positions taken on tax returns" (677 F.2d at 219). It was this perceived "clash between two important congressional policies"—the "national public interest [in] insur[ing] the maintenance of fair and honest [securities] markets" and the public interest in equitable tax collection—that induced the *Arthur Young* court to carve out a qualified privilege for tax accrual workpapers. 677 F.2d at 219-220.

This rationale is wholly absent here because, as petitioner concedes (Pet. 5), it is not a publicly-held corporation and is not subject to any reporting requirements under the federal securities laws. Nor has petitioner pointed to any other conflicting statute or countervailing legislative policy that would, in accordance with the analysis in *Arthur Young*, support the privilege it seeks to establish.[4] At bottom, petitioner contends that an accountant's privilege is justified by its notion of sound public policy. But the Sixth Circuit recently rejected just such an argument, refusing to hold a corporation's internal audit reports privileged from disclosure in response to an IRS summons on analogy with *Arthur Young*, and this Court denied certiorari. *Leaseway Transportation Corp.* v. *United States*, No. 81-3726 (6th Cir. Apr. 19, 1983), cert. denied, No. 83-65 (Nov. 7, 1983).[5]

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[4] Petitioner appears to suggest (Pet. 17-21) that it might at some point in the future make a public offering of stock, and that there thus exists a *potential* conflict with the policies of the securities statutes. But this is just another way of conceding that no actual conflict exists. Nor is there any merit to petitioner's contention (Pet. 21-22) that, wholly apart from the securities laws, there is a "public interest" in the independent auditing process that warrants recognition of an accountant's privilege. Petitioner cites no congressional policy to this effect, and its argument boils down to a contention that the absence of a privilege will impair the candor of accountant-client relations, an argument this Court explicitly rejected in *Couch*.

[5] Although petitioner (see Pet. i) does not seek review of the court of appeals' holding that the tax accrual workpapers were "relevant" within the meaning of Section 7602, it does assert in passing (Pet. 15 n.4) that the Eleventh Circuit's holding in this respect conflicts with the Tenth Circuit's decision in *Coopers & Lybrand*, *supra*. This contention is unfounded. As we have argued in *Arthur Young* (U.S. Reply Br. at 11-16 &

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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MARCH 1984

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n.15), *El Paso* (U.S. Br. at 9-12, *El Paso Co.* v. *United States*, No. 82-716), and *Leaseway Transportation* (Br. in Opp. at 5-7, *Leaseway Transportation Corp.* v. *United States*, No. 83-65), the courts of appeals, including the Tenth Circuit, are unanimous in applying the same legal test to assess the relevancy of material sought by an IRS summons—whether the material "might throw light upon" the correctness of the taxpayer's returns. *E.g.*, *United States* v. *Southwestern Bank & Trust Co.*, 693 F.2d 994, 996 (10th Cir. 1982); *United States* v. *Will*, 671 F.2d 963, 966 (6th Cir. 1982); *United States* v. *Noall*, 587 F.2d 123, 125-126 (2d Cir. 1978), cert. denied, 441 U.S. 923 (1979). (Copies of our briefs in *El Paso* and *Leaseway Transportation* are being sent to petitioner's counsel.) The *Coopers & Lybrand* court, in declining to enforce a summons for tax accrual workpapers on relevancy grounds, stated that such issues "must be [decided] on an ad hoc basis" (550 F.2d at 620) and rested its holding largely on the factual findings made by the district court.

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